

Message Text

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ACTION EUR-12

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INFO AMEMBASSY REYKJAVIK

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SUBJECT: EDRC ANNUAL REVIEW OF ICELAND, OCTOBER 21

REF: OECD DOCUMENT EDR(74)3L

1. SUMMARY: EDRC HAD SPIRITED DISCUSSION WITH ICELANDIC DELEGATION (LED BY SIGURDSSON) REGARDING PROBLEMS OF INFLATION AND BALANCE OF PAYMENTS. SECRETARIAT HIGHLIGHTED DANGER THAT CURRENT 40 - 50 PERCENT RATE OF INFLATION MAY LEAD TO SEVERE DISTORTION OF SOCIAL AND ECONOMIC FRAMEWORK, TO WHICH ICELANDERS REPLIED THAT MEASURES ALREADY INTRODUCED OR UNDER CONSIDERATION SHOULD BE SUFFICIENT TO BRING INFLATION RATE DOWN TO MORE MANAGEABLE 25 - 30 PERCENT RATE IN 1975. SECRETARIAT ALSO NOTED UNFORTUNATE COINCIDENCE FOR BOP OF DECLINING DEMAND FOR EXPORTS AND SEVERE INCREASES IN IMPORT PRICES IN 1974. ICELAND EXPECTS CURRENT ACCOUNT DEFICIT TO IMPROVE IN 1975 TO ABOUT 4.5 PERCENT OF GNP (7 - 7.5 BILLION KRONA). CHAIRMAN SUMMARIZED SITUATION IN ICELAND AS SERIOUS, BUT SAW POSITIVE INDICATIONS THAT ICELAND AT LAST COMING TO

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GRIPS WITH LONG-STANDING POLICY CHALLENGES. END SUMMARY.

2. INFLATION OUTLOOK: ICELANDIC DELEGATION CONFIRMED SECRETARIAT EXPECTATION THAT 1974 INFLATION RATE WILL BE ABOUT 43 PERCENT. THEY NOTED THAT FINAL QUARTER OF 1974 AND FIRST QUARTER 1975 MAY WELL SEE EVEN HIGHER ANNUAL RATES DUE TO SHORT RUN ADVERSE EFFECTS OF (A) AUGUST DEVALUATION OF KRONA BY 17 PERCENT (B) INTRODUCTION OF NEW INDIRECT TAXES, (C) WAGE QUALIZATION PAYMENTS, AND (D) CONTINUED PASS-THROUGH OF HIGHER IMPORT PRICES TO RETAIL LEVEL. ICELANDERS EXPECT SITUATION TO IMPROVE THEREAFTER AS RESULT OF DISCRETIONARY MEASURES AND DEMAND MANAGEMENT POLICIES, WITH 25 - 30 PERCENT INCREASE IN INFLATION RATE OVER FULL YEAR 1975 AND SOMETHING BELOW 15 PERCENT ANNUAL RATE BY END OF YEAR. ICELANDERS SAW VERY LITTLE EVIDENCE TO SUPPORT SECRETARIAT'S FEAR THAT PRESENT HIGH INFLATION RATES WOULD THREATEN SOCIAL AND ECONOMIC INSTITUTIONS. THEY AGREED, HOWEVER, THAT MORE EMPHASIS WOULD HAVE TO BE PUT ON DEMAND MANAGEMENT IF DISCRETIONARY CONTROLS OVER PRICES AND WAGES WERE TO BE EFFECTIVE IN COUNTERING INFLATION.

3. ANTI-INFLATION POLICIES: ICELANDIC DELEGATION MADE TENTATIVE FORECAST THAT MEASURES TO RESTRAIN DEMAND WOULD LEAD TO REDUCTION IN GROWTH OF GNP IN 1975 TO BETWEEN 1 AND 1.5 PERCENT, WHICH WOULD HELP TO REDUCE STRAIN ON RESOURCES. IN ADDITION TO MEASURES ALREADY TAKEN TO RESTRAIN DEMAND (E.G., FREEZING INDEXATION OF WAGES AND SALARIES, INTRODUCING NEW INDIRECT TAXES, RESTRICTING INVESTMENT CREDIT FUND LENDING), GOI INTENDS TO REFORMULATE BASES FOR INDEXATION AND PRICE CONTROLS SO THAT INDEXATION AGREEMENTS HAVE ESCAPE CLAUSE AT TIMES OF EXTERNAL STIMULUS TO INFLATION, AND PRICE CONTROLS ARE ON SOME OTHER BASIS THAN PRESENT SYSTEM OF CONTROLLED MARK-UPS. ON FISCAL SIDE, ICELANDIC DELEGATION DID NOT AGREE THAT INTRODUCTION OF MORE ELASTIC TAX STRUCTURE TO TAKE ADVANTAGE OF FISCAL DRAG WOULD BE APPROPRIATE FOR ICELAND. HOWEVER, GOI INTENDED TO MOVE TOWARDS PAY SYSTEM FOR INCOME TAXES AS SOON AS PRACTICABLE. ICELANDERS ALSO NOTED, LIMITED OFFICIAL USE

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WHEN CHALLENGED REGARDING PLANNED REDEMPTION OF INDEX-LINKED SAVINGS BONDS IN 1975, THAT THEY WERE MAKING FULL PROVISION FOR THIS IN 1975 BUDGET, BUT WOULD OFFER ATTRACTIVE ALTERNATIVES IN EFFORT SOAK UP EXCESS LIQUIDITY. ON MONETARY POLICY, ICELAND IS CONSIDERING COMPREHENSIVE REVISION OF CREDIT POLICY, ESPECIALLY WITH REGARD TO INDEXATION OF CREDIT INSTRUMENTS. ATTEMPTS WILL BE MADE TO OBTAIN VOLUNTARY AGREEMENT OF

NON-BANK FINANCIAL INSTITUTIONS TO LIMIT CREDIT
AVAILABILITY. HOWEVER, GOI NOT YET READY (OR ABLE)
TO ENFORCE VOLUNTARY CREDIT RESTRAINTS ON COMMERCIAL
BANKS, WHICH, ACCORDING TO SECRETARIAT, HAVE BEEN
GENERALLY IGNORED BY BANKS.

4. BALANCE OF PAYMENTS. ICELANDIC DEL EXPECTS CURRENT

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ACCOUNT DEFICIT IN 1974 TO REACH 12.4 BILLION KRONA, OR
9.25 PERCENT OF GNP. HOWEVER, ICELAND IS CONFIDENT
THAT THIS CAN BE FINANCED BY FOREIGN BORROWING (NOT
YET OBTAINED), RUNDOWN OF RESERVES, AND DRAWINGS ON
IMF. CRITICAL PERIOD WILL BE NEXT FEW MONTHS WHEN
ADVERSE IMPACT OF DEVALUATION WILL BE FELT, AND BEFORE
DOMESTIC DEMAND RESTRAINT BEGINS TO BITE. IN ADDITION
SOME EDRC MEMBERS FELT THAT REMOVAL OF IMPORT DEPOSIT
SCHEME MIGHT GIVE SHORT TERM IMPETUS TO IMPORTS. IN
1975, ICELANDIC DEL WAS HOPEFUL THAT CURRENT ACCOUNT
DEFICIT COULD BE REDUCED TO ABOUT 7 - 7.5 BILLION

KRONA, AND EVEN THOUGHT THAT SUCH AN ESTIMATE MIGHT
BE TOO PESSIMISTIC.

5. CONCLUSION. CHAIRMAN CONCLUDED THAT ICELANDIC
ECONOMIC SITUATION, THOUGH SERIOUS, HAD
ELEMENTS OF POSITIVE MOVEMENT TOWARD REASSESSMENT OF
TRADITIONAL SACROSANCT POSITIONS. THIS WAS HOPEFUL
DEVELOPMENT WHICH COULD BRING LONG TERM BENEFITS TO
ICELAND IF FOLLOWED THROUGH IN MANNER INDICATED.
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7. ICELANDIC DEL CIRCULATED HIS OPENING STATEMENT AND
REPLIES TO MAIN ISSUES PAPER. THESE HAVE BEEN AIR
POUCHED TO STATE EUR/RPE AND REYKJAVIK.
TURNER

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